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Prepared by:
Valerie L. Peterson, J.D.
CEO, ElderCounsel LLC

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Valerie L. Peterson, J.D.
CEO
ElderCounsel, LLC
www.eldercounsel.com

The Department of Veterans Administration (VA) has provided new eligibility rules for wartime Veterans and surviving spouses of wartime Veterans who are eligible for VA pension benefits. The rules addressed trusts by first defining them, then setting out how and when transfers to a trust would be penalized. These rules will go into effect on October 18, 2018.

A trust is "a legal instrument by which an individual (the grantor) transfers property to an individual or an entity (the trustee), who manages the property according to the terms of the trust, whether for the grantor's own benefit or for the benefit of another individual."[1] For purposes of calculating a penalty period, "uncompensated value" means the difference between the fair market value of an asset and the amount received. With regard to transfers to a trust, annuity or other financial instrument or investment, "uncompensated value" means the amount transferred.[2]

[1] 38 CFR §3.276 (a)(5)(ii)(B)
[2] 38 CFR §3.276 (a)(6) *This definition was expanded in the final rule to address trusts, annuities and other financial instruments.*

A transfer to a trust would not be penalized if the claimant/grantor retains control and the ability to liquidate for the claimant/grantor's benefit. [3] Those assets would be counted as part of a claimant's net worth, though.

The new rules also provide an exception to the trust transfer provisions. A Veteran, a Veteran's spouse, or the surviving spouse of a Veteran may transfer assets to a trust established on behalf of a child if the VA has rated the child incapable of self-support pursuant to 38 CFR §3.36 AND there is no circumstance where the trust assets can benefit the Veteran, the Veteran's spouse or the Veteran's surviving spouse.[4]

The prior provisions of 38 CFR 3.276 that defined "total relinquishment" of an asset (including the statement that a transfer to a relative residing in the home would not satisfy that definition) have been replaced by the new rules that define net worth and covered assets.[5] Net worth now includes the income and assets of the Veteran and any dependents and is subject to a limit that equals the maximum Community Spouse Resource Allowance in effect at the time the application is filed. In 2018, this number is $123,600 and increases each year.

In addition to the net worth limit, beginning 10-18-18, any "covered assets" transferred will be subject to a lookback period of 36 months, and will be subject to a penalty period.[6] The effect of the lookback and penalty period is that claimants with substantial assets will now need to plan 36 months in advance, as any transfers of covered assets will be penalized using a divisor

[3] See supplementary information provided with the final rules, https://www.federalregister.gov/documents/2018/09/18/2018-19895/net-worth-asset-transfers-and-income-exclusions-for-needs-based-benefits
[4] 38 CFR §3.276(a)(8)(d)
[5] 38 CFR §3.274(a)-(b)
[6] 38 CFR §3.276

amount that is equal to the maximum monthly pension amount for a Veteran with one dependent. In 2018 this number is $2,169.

Previously, the VA had provided little guidance in the area of trusts and how they may be used in the context of VA pension benefits planning. In fact, there are only 5 reported General Counsel's opinions the last 19 years, and only 1 since 1997. Because nothing in the new rules addressed what is contained in the opinions, we believe they will still be followed by the VA. There are also recent decisions from the Board of Veterans Appeals (BVA) that discuss how assets in an irrevocable trust will be considered for VA pension purposes. Below is a summary of the five reported General Counsel opinions, all of which can be found on the General Counsel website, https://www.va.gov/ogc/precedentopinions.asp as well as some recent decisions, which can be found on the BVA website, https://www.index.va.gov/search/va/bva.jsp.

General Counsel Opinions

In VAOGCPREC 72-90, the claimant, who was in a VA facility and was receiving pension, became the beneficiary of a testamentary trust worth $22,000. Under the terms of the trust the Trustee had sole discretion to provide funds for the veteran's comfort, but not as a substitute for support and maintenance to which the veteran was legally entitled from other sources. Once the trust was funded, the claimant's pension was stopped as his income and assets exceeded the limit then allowable.

The General Counsel's opinion recognized that the veteran held no legal title to the trust assets but only held an equitable interest as a beneficiary. The opinion concluded that only the portion of the trust property, including trust-related income, that has actually been made available for the veteran's use, is countable for purposes of determining pension eligibility.

VAOPGCPREC 64-91 dealt primarily with questions pertaining to a veteran's home and how it is counted. However, one question dealt directly with trusts, and whether a veteran who receives income as beneficiary of a private trust fund should have the entire value of the trust fund be included in his estate. The General Counsel reaffirmed its prior holding in 72-90 stating that trust assets should not be included in the veteran's estate except to the extent trust assets are allocated and are available for the veteran's use.

VAOPGCPREC 73-91 involved a veteran who was receiving pension and received an inheritance from his son in the form of life insurance proceeds. The veteran/claimant wanted to set up a trust for the benefit of his three grandchildren and no benefit coming back to him.

The opinion held that as long as the trust assets were for the benefit of the veteran's grandchildren and the veteran could not benefit from the income or principal, the trust assets would not be counted as part of his net worth for pension purposes. (As a side issue, the opinion also notes that the receipt of the life insurance proceeds would be income to the veteran that could disqualify him from pension benefits for up to a year). Unfortunately, we do not know whether the trust involved was an intentionally defective grantor trust.

The opinion in 73-91 raises the issue of whether the trust would be counted if the grandchildren resided in the veteran's home pursuant to 38 CFR §3.276(b) which applies to transfers of assets and states, "[a] gift of property to someone other than a relative residing in the grantor's household will not be recognized as reducing the corpus of the grantor's estate 'unless it is clear that the grantor has relinquished all right of ownership, including the right of control of the property." Because distributions only vest when each grandchild turns 21, the opinion held this as a future interest rather than a present interest in the trust assets, therefore 38 CFR §3.276(b) may not apply. However, the second issue to consider if the grandchildren were living

in the home is whether the veteran/claimant benefitted in any way from the trust assets. The answer to this was not given as the facts did not state whether the grandchildren were in fact living with the veteran/claimant.

VAOPGCPREC 15-92 answered the question of how a life estate interest should be treated. In 15-92, the surviving spouse of a veteran held three life estate interests in property she and her husband transferred to their children the year prior while retaining the right to farm the land and collect the rents therefrom. Upon the death of her husband, she applied for death pension and was denied in part due to excessive net worth as a result of the three properties in which she held a life estate interest.

The General Counsel's opinion examined 38 C.F.R. §3.276(b) for help in determining whether a transfer occurred when a life estate was retained and a remainder interest given away. In defining what a life estate is, General Counsel also looked to C.J.S. and the American Law of Property to define the rights of a holder of a life estate, noting that a life estate holder has a duty to the remaindermen even though the holder of the life estate has exclusive use and enjoyment of the property during his/her lifetime. Accordingly, the General Counsel held that the wife had not relinquished all rights of ownership in the three properties but instead maintained complete control over the life estates in each. Therefore, all three properties were considered as part of her net worth for VA pension purposes. <u>The new rules do not address life estate interests, so it is assumed that the current rules will continue to apply</u> and the full value of the property will be counted.

The final reported opinion concerning an irrevocable trust is perhaps the most damaging one. VAOPGCPREC 33-97 considered whether the assets held in a self-settled special needs

trust should be counted as either income or net worth (or both) for purposes of pension. Unfortunately, the answer came back as "yes."

In 33-97, an "Irrevocable Living Trust" was established for the surviving spouse of a veteran. A child of the surviving spouse was named as trustee. The trust stated that some or all of the income and principal of the trust fund may be paid by the trustee to or for the benefit of the surviving spouse for the surviving spouse's "special needs for health, safety and well being when such requisites are not presently being provided by any public entity, office or department of the beneficiary's state of residence, or of any other state, or of the United States."

Other pertinent terms of the trust included the following:

> "Special needs" shall include, but not be limited to, medical and dental expenses; equipment; programs of training, education and treatment. Trustee shall have no discretion in Trustee's distribution of income and principal for special needs . . . . The express purpose of this trust shall be to provide for beneficiary's extra and supplemental needs for health, safety and well being in addition to and over and above the benefits provided by any public entity, office or department of the beneficiary's state of residence . . . or of the United States. It is the express purpose of the Trustor to use this trust estate only to supplement other benefits . . . .
>
> Distributions to beneficiary . . . are to be considered as from a discretionary, and not a basic support, trust, and the beneficiary's trust interest shall not be used to provide basic food, clothing and shelter, nor be available to the beneficiary for conversion for such items, unless all governmental and nongovernmental benefits for which the beneficiary is eligible as the result of disability or handicap have first been fully expended for such purposes.

Id.

The opinion first attempted to analogize the special needs trust 15-92 with the special needs trust established in 33-97 noting, "The trust document at issue here establishes a so-called 'living trust,' an arrangement somewhat analogous to a life estate." While comparing the two, General Counsel opined that although the spouse here did not have the mental faculties to exercise control over the trust property, "the surviving spouse could be considered as exercising

control over the trust assets if the surviving spouse gave the trustee control over the assets while the surviving spouse retained sufficient mental faculties and provided specific instructions concerning the circumstances under which trust assets would be used for the surviving spouse's benefit, or if someone lawfully empowered to act on her behalf established the trust. In this manner, the surviving spouse could be considered to exercise 'control' over the trust assets even though the surviving spouse is now completely incapacitated."

In painstaking fashion, General Counsel went on to explain that the literal terms of the trust make the trust assets available for the spouse's support. While the opinion noted the express terms of the trust which state that no part of income or principal shall be considered available for purposes of determining eligibility for government benefits, "such a unilateral declaration has no legal effect with respect to VA's determination of entitlement to benefits, which is governed by Federal law."

Although the reasoning in 33-97 lacked a certain legal soundness, it appears that a self-settled special needs trust is not a viable planning tool for VA pension purposes. Transfers to a pooled trust would probably be evaluated in much the same way, and should be avoided if VA pension is desired.

Recent Board of Veterans Appeals (BVA) Decisions

In Docket No 16-02 867 decided Feb. 16, 2017[7] the claimant transferred approximately $100,000 to an irrevocable trust in 2014, prior to applying for VA pension benefits. (An annuity was also purchased but will not be discussed here.) The opinion states that the irrevocable trust was "established in the name of his son." The son was the trustee, and the Veteran was an income beneficiary. According to the terms of the trust the Veteran had no ownership or rights to

[7] Opinion may be found here: https://www.va.gov/vetapp17/files1/1704793.txt

principal and the trustee had no authority to distribute principal to the Veteran. However, the trust stated that the trustee is "required to maintain the trust for the benefit of the lifetime beneficiaries." The Veteran was the only income beneficiary named in the trust.

In the opinion, the Board notes that based on the M21-1MR provisions and prior General Counsel opinions, the VA should include trust assets in net worth calculations if those assets are available for use for the claimant's support. If the Veteran is receiving a benefit from trust expenditures, then a determination must be made to determine whether the Veteran is exercising such control and use of trust assets that they are available to the Veteran.

Because the income was available to the Veteran and the trustee was required to maintain the trust for the benefit of the lifetime beneficiaries (including the Veteran), then the Board found that the Veteran's "income beneficiary interest in the irrevocable trust estate" is countable for net worth purposes. The Board included the entire value of the trust assets for net worth purposes.

A nearly identical result was reached in Docket No. 13-17 549, decided June 15, 2017.[8] There, the Veteran and his spouse transferred approximately $115,000 to an irrevocable trust prior to applying for VA pension benefits. The Veteran and his spouse were the only income beneficiaries and their son was trustee. The trust stated that the trustee's duty was to maintain the trust fund for the benefit of the trust and the beneficiaries. In 2013, the trustee paid the Veteran and his spouse $19,000 from the trust to help with medical expenses.

Quoting prior General Counsel opinions that reviewed under what circumstances trust assets should be counted, the Board noted that trust assets would be countable unless (1) it is actually owned by the claimant; (2) the claimant possesses such control over the property that the claimant may direct it to be used for the claimant's benefit; or (3) funds have actually been

[8] https://www.va.gov/vetapp17/files1/1704793.txt

allocated for the claimant's use. The VA may also make a case by case determination if a Veteran is receiving benefit from the trust.

The Board held that trust assets were countable as part of net worth because the Veteran and the spouse were income beneficiaries, the trustee was required to maintain the trust for the benefit of the beneficiaries, and the Veteran and his spouse benefited from trust assets when $19,000 was paid to them in 2013.

Contrast the above with a favorable BVA opinion that involved an irrevocable trust, Docket No. 15-23 806, decided March 6, 2017.[9] In this case, the Veteran's surviving spouse was receiving death pension. Her benefits were discontinued after her home, which was held in an irrevocable trust, was sold.

The irrevocable trust was established in 2010, at which time the home was transferred into the trust. Neither the surviving spouse nor the Veteran (alive at the time) were income or principal beneficiaries of the trust. The trust stated that the Veteran and surviving spouse, "shall have no right or ownership or benefit to the principal or interest of the Trust property." The beneficiaries were the appellant's children and their descendants. Interestingly, the trust allowed the trustee to make gifts to the lifetime beneficiaries for charitable or religious purposes, or for the maintenance or health needs of the appellant.

When the home was sold in 2014, the surviving spouse was receiving death pension. Those benefits were discontinued with the VA finding that the home proceeds were part of her net worth. The BVA sided with the surviving spouse, finding that the irrevocable trust only lists her children as beneficiaries, and any gifts given to the spouse from trust assets (as had happened in the past) were not shown to be regular period payments exclusively allocated for her actual

[9] https://www.va.gov/vetapp17/files2/1706739.txt

use. The Board further found that the appellant had no control over the trust assets nor any property interest in the trust, therefore it was unreasonable to believe that the house proceeds would be used for the spouse's maintenance. Her death pension benefits were reinstated.

Where does that leave irrevocable trusts for VA purposes?

The use of an irrevocable trust for VA pension purposes is a viable planning strategy, especially now that many Veterans or surviving spouses will need to engage in proactive planning – meaning they must plan in advance and wait out the 36-month lookback period. The irrevocable trust described below can also work for Medicaid planning purposes, meaning you don't have to guess which benefit will be access first in the future.

The use of an intentionally defective grantor trust (also referred to as a Medicaid Asset Protection Trust™) may be used as long as it is clear that the grantor has no right to income at all. It is also advisable to only place non-income producing assets in this type of trust as the VA has access to a claimant's tax returns. If income in this type of irrevocable trust is reported as belonging to the grantor, the VA could question whether the claimant has given up complete control of the property, and whether the claimant is benefitting from trust income or principal. In the author's opinion, it is safer not to place assets (other than a home as described below) into an intentionally defective grantor trust if the purpose is to qualify for Aid and Attendance.

A common use of this type of trust in the VA context is for the claimant's home as the 121 exemption may be preserved for the home, and capital gains will be taxed according to the grantor's individual capital gains rate. Under the new rules, the transfer of the home will not be penalized as it is not a "covered asset." It is advisable to draft the trust to require distribution of

the proceeds to the lifetime beneficiaries immediately upon the sale of the home to avoid any income being reported on the grantor's tax return in the event the proceeds are left in the trust.

To protect the 121 Exemption and any local homestead exemptions, you will want to include special retained rights in the home, as well as a special power of appointment to change beneficiaries at the grantor's death. This will preserve the step-up in basis at death. Make sure, however, that your power of appointment is exercisable by will only and that the language does not give the grantor the power to appoint accumulated income as this will confer grantor trust status over trust income – a result we are trying to avoid.

Be sure your trust states that when the home is sold the trust will terminate and the assets will be paid out to the lifetime beneficiaries, or to another irrevocable trust that is not defective.

A nongrantor irrevocable trust may also be used for VA pension purposes, again where the grantor has no access to income or principal. We suggest mandatory payment of income to the lifetime beneficiaries to avoid any grantor trust "traps." The income is taxable income to the income beneficiaries. However, if they are also beneficiaries of principal, the income beneficiaries can take a distribution from the trust to cover their increased tax liability.

With this type of trust, there is very little risk of the VA questioning whether the veteran has relinquished all control of the trust assets or is benefitting at all from trust income or principal. Furthermore, by reserving a limited testamentary power of appointment to change beneficiaries, the trust assets will receive a step up in basis at the death of the grantor.

You also want to make sure payment of income is mandatory, but not payment of principal.

An irrevocable third-party supplemental needs trust may also serve as a valuable planning tool for VA pension purposes. If the claimant is the grantor, it must be irrevocable, again so

there is no argument by the VA that the claimant/grantor has not relinquished control of the assets placed into the trust. An irrevocable sole benefit trust would also appear to work in the context of VA pension planning. Just remember that transfers to any irrevocable trust, other than one established for the benefit of a child incapable of self-support prior to age 18, will be subject to the lookback and penalty period after October 18, 2018.

Drafting tip: In ElderDocx you can use the Third-Party Supplemental Needs Trust document group or the Sole Benefit Trust Document group. While the Third-Party Supplemental Needs Trust may be revocable or irrevocable, for VA purposes you should choose irrevocable. The distribution standard choices will be supplemental and discretionary or just discretionary. If Medicaid may be an issue for the beneficiary in the future, it is important to check your state's rules to determine whether a purely discretionary trust will count against the beneficiary for Medicaid purposes.

The Veterans Asset Protection Trust®

ElderCounsel has taken the characteristics of each intentionally defective trust and nongrantor trust described above and combined them into one trust, the Veterans Asset Protection Trust® (VAPT®). While divided into a subtrust for the principal residence (that is treated as an IDGT) and a subtrust for all other assets (treated as a nongrantor trust), the VAPT allows for more efficient administration of trust assets and ensures that no mistake can be made during funding or upon the sale of the principal residence. Clear instructions are provided to the trustee to protect the 121 exclusion, how to handle proceeds upon sale of the grantor's home, how to allocate capital gains on the home, and a restriction upon renting the principal residence is in place.

Furthermore, decanting provisions are built in to allow for changed circumstances that may require a change in the structure of one of the subtrusts, or a change in how the subtrust is funded. Great care was taken to ensure the correct trustee options were chosen in the interview to allow decanting in the future if needed.

Conclusion

Irrevocable trusts will play an even bigger role in Veterans pension planning with the new lookback and penalty period rules in place. Attorneys in this area must use great caution when drafting any type of irrevocable trust to avoid having assets counted due to income being available to the grantor, or the grantor retaining control over trust assets.